FARM BUSINESS INCORPORATION

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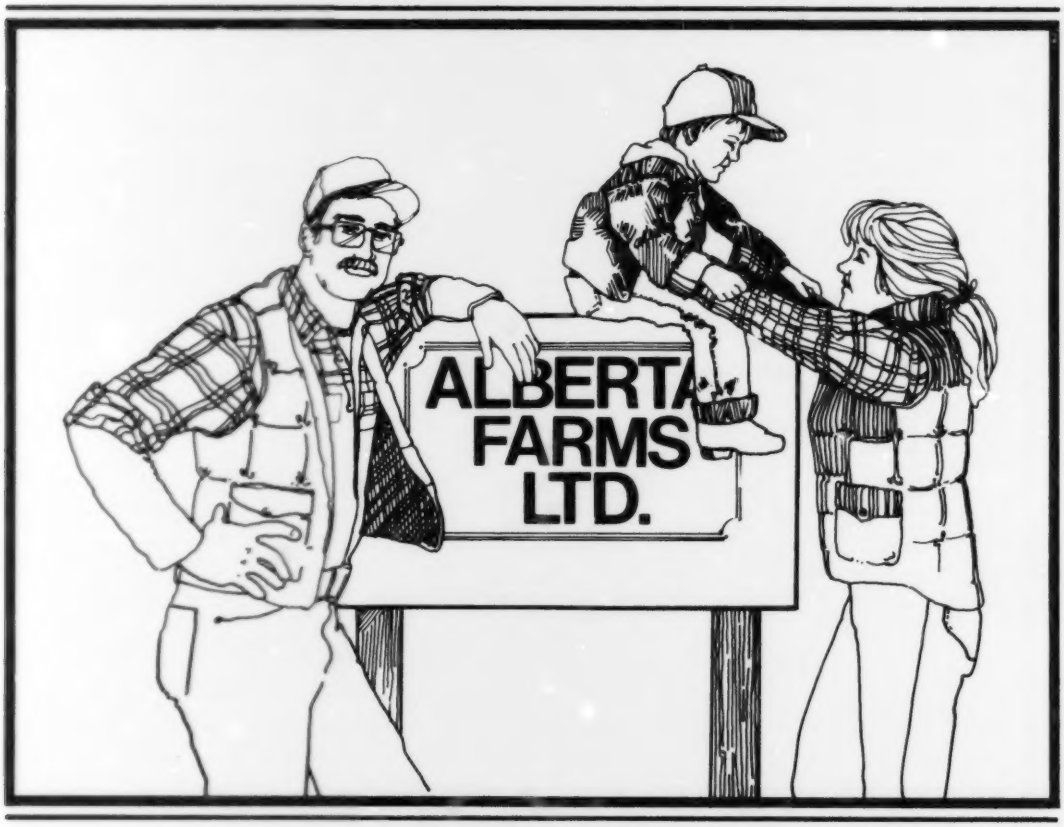

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FARM BUSINESS INCORPORATION

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Alberta
AGRICULTURE
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PREFACE

Increased capitalization, larger debt loads and higher farm incomes have increased the interest in financial management and have encouraged farmers to examine various types of business organizations. Since 1978, changes in the Income Tax Act have made the corporate form of business arrangement more attractive to many farm managers.

This publication has been prepared to provide the reader with a basic understanding of farm corporations. Various capital structures, distribution of profits and losses, factors to consider with respect to farm incorporation and the income tax and estate planning features of a company are discussed.

A case study entitled "Alberta Farms Ltd." is presented to tie together the concepts presented in the publication. The example provides an overview of personal and business considerations and procedures involved in establishing a farm company.

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INTRODUCTION

Throughout modern history, agriculture has kept abreast of the technological explosion. The farm business today barely resembles the farm of our fathers. Three hundred and fifty horse-power tractors, massive combines and complete electronic feeding systems now dominate the farm scene. In conjunction with this expansion, an even more complex area has evolved - financial management.

The farmer today comes into contact with transactions and information relating to financial management almost daily. Such matters include credit, real estate, leases and sales, business organizations, purchase and sale agreements, income tax statutes and accounting records. Farmers' financial and personal success depends heavily on their understanding of the concepts and consequences of each decision. By analyzing these matters, farmers can formulate business and estate plans that will assist them in reaching their goals and objectives as well as those of their families.

In this business organization, farmers will not only have to consider their family needs and the needs of their heirs, but also the effect of inflation, the nature of their assets and the attitudes of their business partners. They will also have to take into account taxes affecting their income, their gifts and the assets they will leave at death.

Since tax planning has a major influence on the decision as to what type of farm business organization to implement, the reader will soon discover taxes are the most recurring subject matter. It must be stressed, however, that tax management is not the sole factor to be considered. What appears to be a good business estate plan may collapse if it is built solely around income tax considerations.

The best business organization and estate plan is one which evolves from a balanced consideration of all factors, not only by the person directly involved but also the family and close advisers such as the accountant and lawyer. Incorporation is one method of organizing the family farm to meet these business and personal goals. It is with this in mind that our publication was written.

A corporation is one method by means of which it is possible to carry on a farming operation. However, it brings with it a degree of complexity which can often mask many of its advantages and disadvantages.

With the recent but significant changes in the provincial law relating to incorporation in Alberta, and with the everchanging income tax system which affects the financial decisions made by the directors and officers of a corporation, it is becoming much more important that the decision to incorporate be a properly informed one.[1]

WHAT IS A CORPORATION OR COMPANY?

Incorporation represents a form of business arrangement which differs substantially from the other common forms of business organization e.g., the sole proprietorship and the partnership. A corporation is a **separate legal entity** (an artificially created legal "person") and is distinct from the persons who are its shareholders. Its assets and liabilities are its own, they do not belong to the shareholders. As a legal entity, the company is subject to the same laws and can do many of the same things a person can do. For instance, it may own personal property, make contracts, sue or be sued in its own name, buy, hold and transfer property.

At the time of the incorporation, the owners of the company (the shareholders) are issued certificates representing their share of stock. A share of stock represents a share of the total net worth of the farm business. Therefore, once a farmer has transferred his property (land, machinery, etc.) to the company, the company becomes the holder of the title to such property. The farmer then retains title only to the allotted shares which he holds as his personal property.

Separation of ownership and management is a characteristic of the corporate farm. A sole proprietor owns the business and makes the management decisions. In the partnership, the partners are the owners and decision makers. In a corporation, the shareholders are the owners but control is by virtue of the NUMBER OF VOTING SHARES an individual holds.

REMEMBER: *Shareholders own shares in the net assets of the corporation but the assets and liabilities of the company are its own.*

1. For example: The province of Alberta is proposing to reduce the amount of income tax applied to income earned from manufacturing and processing carried out in Alberta by 6 per cent effective April 1, 1985 for a five-year period ending March 31, 1990. This will allow qualifying income to be earned without payment of provincial income tax in Alberta.

CAPITAL STRUCTURE

The structure of a company is determined by **share** and **non share considerations**. When a company is created, the incorporators decide the conditions, characteristics and the number of shares of stock. The share characteristics such as voting rights and dividend preference which may be attached to certain shares determine company ownership, control and division of profit. Shares should not be confused with nonshare considerations which may consist of shareholders' loans, notes or even the assumption of a debt.

To provide some general guidance on this topic, the following questions will attempt to answer a few basic questions of interest to farmers. These are:

1) What is the difference between common and preferred shares?
2) Why are there different classes of shares?
3) Are shareholders' loans advisable?

WHAT IS THE DIFFERENCE BETWEEN COMMON AND PREFERRED SHARES?

Under The Alberta Business Corporations Act (ABCA) the specific reference to common shares and preference shares has been removed. However, these general descriptions of shares are still in general use and can be useful in differentiating between shares with different characteristics.

In general terms, a **common share** would be a share which will increase in value as the corporation itself increases in value. Its value will be totally dependent upon the value of the underlying assets owned by the corporation.

By comparison, a **preferred share** will generally not increase in value with the growth of the corporation but, depending upon its characteristics, often will:

- have priority to common shares to the extent of its value in the event the corporation is wound up
- have a fixed dividend rate in priority to common shares
- be subject to repurchase at the request of the shareholder and/or the corporation provided the corporation is financially capable.

The simplest share structure for a farm company would involve a single class of common shares. Common shares receive dividends when directors declare dividends. These dividends are paid out of current or past profits. On the other hand, holders of preferred shares receive dividends as stipulated by the company for these shares. Thus, the designation "preferred" indicates a priority position. This preference may be in the receipt of dividends and/or with respect to the distribution of assets in the event of a company's winding up or declaring bankruptcy.

In estate planning, a parent's estate is often **frozen** at a specified value through the use of preferred shares. Any growth in the business would then go to the common shares, i.e. **growth shares**. These are usually held by the children to ease the transfer of the farm to the next generation. This topic will be discussed in greater depth in the section on estate planning.

WHY DIFFERENT CLASSES OF SHARES?

For an example of a company with both common and preferred shares, see Schedule A on page *23*. Paragraph 2 of this schedule provides an example which sets out the characteristics of three (3) classes of common shares. Each class participates in the profits of the company. The example also provides for one class of preferred shares which has a noncumulative dividend rate of 8 per cent per annum. These preferred shares can be sold back to the company at an amount of $100 per share at the request of the company or of the holder which means they are redeemable and retractable.

While the share characteristics set out in Schedule A appear quite complex, the reader should be concerned only with gaining a basic understanding of the characteristics that it is possible to create. Once you understand these characteristics, you can then discuss how you want to set up a share structure for your particular needs with your legal and accounting adviser.

The share structure referred to in Schedule A provides sufficient flexibility for most farm incorporation matters. However, consideration can be given to the following characteristics:

Voting vs. Nonvoting Shares

In the example provided in Schedule A, only one class of shares has the specific right to vote, therefore, the ability to elect directors or to determine the ultimate course of the company will rest with the shareholders controlling the voting class of shares. Shareholders owning other classes of shares will not be in a position to vote on matters except as provided for under The Alberta Business Corporations Act which provides for voting rights only on specific matters.

Any class of common or preferred shares can be given the right to vote. It need not be limited to one particular class of shares as was done in the example in Schedule A.

REMEMBER: *Given that control of the company lies with the holders of the voting shares, it is important to structure the corporation to put control in the hands of the desired parties.*

Right to Receive Dividends

The right to receive dividends is left up to the directors of the company based upon the financial position of the company. You will note that no specific dividend rate is provided for the Class A, the Class B or the Class C shares.

Cumulative vs. Noncumulative Dividend Payments

The Class D preferred shares have a fixed dividend rate of 8 per cent per annum based upon the redemption value of each share ($100) which is noncumulative in nature. This means that such dividend payments not received in one year are simply lost and will not be an obligation of the company in future years if they are not paid in the current year.

It may be wise to amend the Class D preferred share characteristics to provide for a **cumulative** dividend. This means that, in the event the company is unable to pay a dividend of 8 per cent in one year, this amount is carried forward to the next year as an obligation of the company and is not lost to the Class D shareholder.

In addition, by creating the obligation to pay a dividend of a certain amount as a characteristic of the share itself, the holder of a Class D share is protected from being totally at the discretion of the directors in determining whether a dividend payment will ever be made.

Redeemable and Retractable Preferred Shares

Making a preferred share redeemable means that the company has the ability to repurchase the share from the holder at its option for a fixed sum. In the Class D preferred shares set out in Schedule A, the sum is $100 per share. The company would simply tender to the shareholder an amount equal to $100 per share plus any dividend which might be owing for each share it wished to purchase and the shareholder would be required to sell some or all of his Class D preferred shares.

Adding a retractable option provides the same option to the shareholder as the redeemable characteristic gives to the company. The shareholder is given the ability to request that the company repurchase the shares for an amount equal to $100 per share plus any dividend which might be owing for each share the shareholder wishes to sell to the company. The company would, provided it was financially able, be required to repurchase such shares for the same amount as the shareholder would have received in a share redemption. The characteristics of Class D preferred shares set out in Schedule A provide for both redemption and retraction rights.

Classes of Shares

One of the purposes of having separate classes of shares is to provide for income splitting. By giving Class B shares to your spouse and Class C shares to your children, for example, the directors are in a position to declare dividends on the spouse's shares which vary from those paid to the children. The subject of income splitting is discussed in greater detail in the section on tax planning.

REMEMBER: *The creation of a share structure is dependent on your present and your future needs. Be prepared to discuss your goals and plans with your accountant and your lawyer so that a suitable share structure can be created to meet these goals and plans.*

ARE SHAREHOLDERS' LOANS ADVISABLE?

It is possible to form a corporation through issuing of shares only, but in most instances **nonshare consideration** in the form of shareholders' loarns is advisable. Such loans may, but need not, be subject to an **interest rate**. The combination of shares and promissory notes may hold certain advantages over the receipt of shares only. For example:

- Loans may have an income tax advantage to the company and to the holder of the note. The repayment of the principal is not considered income to the lender. This may be very important in putting assets into a company on a tax free basis pursuant to Section 85 of the **Income Tax Act**. If the amount of the debt equals the **tax cost** value of the farm assets, this can allow the funds to be repaid by the company on a tax free basis. An example of this technique is illustrated in the case study, Alberta Farms Ltd.
- Dividends paid on shares are not a decuctible loan to the company, whereas with a shareholder's note any interest paid pursuant to the terms of the note may be deducted. In summary, the recipient will be faced with a tax liability for the interest received but not the principal payments.
- Instalment payments, unlike dividends on shares, are not dependent upon profits before they can be legally paid out. As a result, they provide a more reliable cash flow for the farmer. This is especially important for parents during retirement.
- The farmer would not have to sacrifice any part of his voting control as might be the case if he had received voting shares (either preferred or common) and later had to sell or have the company redeem the shares to provide cash.

DISTRIBUTION OF PROFITS AND LOSSES

Under a corporate structure profits are not treated in the same way as under a sole proprietor or partnership. The fundamental differences are:

- In an unincorporated business an owner cannot pay himself a salary which is deductible for tax purposes, and may only pay a **reasonable** salary to family members. In a corporation all salaries are deductible provided they are reasonable for the services rendered.
- After salaries are deducted and the profit level determined, a corporate tax is levied. In Alberta, the rates range from 20 per cent to 47 per cent depending on the size of business and type of income. After the corporation has paid its tax bill, the remaining funds can either be left in the company as retained earnings or distributed to the shareholders as dividends.
- If both salaries and dividends are paid, the shareholder is subject to tax on both types of income. Although there are two applications of tax, one at the company level and one at the individual level, the combined tax bill can be less as a result of the special tax rules that are applied to dividends. These calculations will be illustrated in the section on Tax Planning.

The following example should help to clarify this section:

Company A is owned and operated by Mr. and Mrs. Brown. The company experienced gross farm sales of $100,000 with operating expenses of $50,000 in 1987. Salaries paid were $15,000 to Mr. Brown and $5,000 to Mrs. Brown. Dividends declared were $10,000 divided equally. What is the income for the company and Mr. and Mrs. Brown?

COMPANY A

Gross Farm Sales	$100,000	
Operating Expenses	50,000	
Salaries	20,000	
Profits	$30,000	
Tax Levied @ 20% (Active Bus. Income)	6,000	
Net after-tax profits	$24,000	
Dividends Declared	10,000	
Retained Earnings	$14,000	
Personal Income	Mr. Brown	Mrs. Brown
Salaries	$15,000	$ 5,000
Dividends	5,000	5,000
TOTAL PERSONAL INCOME	$20,000	$10,000

As demonstrated above the net income would be $30,000 for the company and $20,000 and $10,000 respectively for Mr. and Mrs. Brown.

It is important to note that all **net after-tax profits** need not be distributed as dividends. Remember, dividends from the retained earnings of a corporation are an optional payment determined by the directors. Some retained earnings (which have already been taxed) may be left in the company for a variety of reasons:

- to provide a sound financial base on which to borrow against or fund future expenditures
- to equalize dividends between good times and bad
- to enable the company to withstand cyclical price swings common in agriculture
- to allow a gradual growth in the business
- to provide for the increased cost of replacements for fixed assets especially in times of inflation and
- to enable the company to redeem any preferred shares.

Corporate owners can find themselves having to lend money back to their own company because the dividends distributed were too large. Since the personal tax rate on dividends and salaries is usually greater than the applicable corporate tax rate, a reduction of actual purchasing power occurs. It is better to expand or pay off liabilities with 80¢ dollars (assume 20 per cent corporate rate) than 75-65¢ dollars (assuming a personal tax rate of 25-35 per cent, the norm for many farm taxpayers).

CORPORATE LOSSES

In many farm units, off-farm employment is a significant factor in the viability of the operation. In unincorporated businesses any operating losses can be applied against the off-farm income, thereby reducing the overall taxable income. This results in a substantial tax refund for some individuals. Losses do not mean that the operation is in dire financial straits. For example, many expanding farms filing on the cash basis show a net cash operating loss but are still financially sound. Any losses which are incurred in a company, however, **cannot be deducted** from other income earned by its shareholders.

This point is very important as off-farm employment is a financial necessity for many beginning and developing farmers. If an operating loss is forecast in the beginning years, why incorporate and not be able to write-off these business losses against employment income and obtain a tax refund? The rules regarding the application of business losses are contained in Section 31 of the Income Tax Act and are commonly referred to as the part-time farmer rules. *For more information on this topic, please refer to pages 36-38 of our Tax Management Strategies for Alberta Farmers, Agdex 837, available from Print Media, Alberta Agriculture, 7000 - 113 Street, Edmonton, Alberta T6H 5T6 or Alberta Agriculture district offices.*

REMEMBER: *The corporation is a separate taxpayer. If it incurs a loss, chances are it will not*

have alternate sources of income to which this loss may be applied. Farm operating losses may be carried forward up to ten years and applied against future farm profits of the corporation.

SALARIES VS. DIVIDENDS

In the preceding commentary we have indicated that a corporation has the option of distributing the profits either in the form of dividends or salaries. An important and common question that arises is: What combination of salary and dividend will reduce your income tax liability to the lowest level? This depends on a number of factors including the level of other personal income, the type of company and income, and the utilization of contributions to income-deferring plans such as a registered retirement savings plan. Many accounting firms have computer programs that will assist you in evaluating your situation.

The following example illustrates the effect of a salary-dividend split:

Company B, a farm corporation qualifying for the small business rate of tax, has generated $100,000 of net income. Both Mr. and Mrs. Schultz are active in the business and are trying to decide to take either $40,000 in the form of salary or $20,000 in salary and $20,000 in dividends.

NOTE: To simplify the illustration, only personal exemptions which amount to not less than $4,220 have been used for each alternative. (Note: All surtaxes have been ignored.)

By taking a mix of salary and dividend, Mr. and Mrs. Schultz's 1987 tax bill is reduced by $410 ($19,844 - $19,434).

*Dividends are not a deductible expense to the company.

REMEMBER: *There are an infinite number of combinations of salary and dividend splits. By consulting with your accountant, you can identify the most advantageous alternative.*

TABLE ONE - SALARY ONLY

	COMPANY	HUSBAND	WIFE	
Income	$100,000			
Salary Taken	(40,000)	$20,000	$20,000	
Net Income	$ 60,000	$20,000	$20,000	
Tax levied	$ 12,000	$ 3,922	$ 3,922	
Total Tax Payable				$19,844

TABLE TWO - SALARY/DIVIDEND SPLIT

	COMPANY	HUSBAND	WIFE	
Income	$100,000			
Salary Taken	(20,000)	$10,000	$10,000	
Dividend*	20,000	10,000	10,000	
Net Income	$ 80,000	$20,000	$20,000	
Tax Levied @ 20%	$ 16,000	$ 1,717	$ 1,717	
Total Tax Payable	$ 16,000	$ 1,717	$ 1,717	$ 19,434

ALTERNATIVE MINIMUM PERSONAL INCOME TAX

As of January 1, 1986 a new tax calculation is necessary and is termed the Alternative Minimum Tax (AMT). This calculation is necessary if an **individual** has earned more than $40,000 of net income for tax purposes plus their personal exemptions. The reason for this Alternative Minimum Tax, according to our Finance Minister Wilson, is to alleviate "a growing public concern about the high-income Canadians who pay little or no personal income tax in any one year by the use of various tax deductions and incentives."

The requirement to pay Minimum Tax is triggered **only** if the Minimum Tax payable is greater than the tax calculated in the normal manner. This will normally occur when an individual has any "tax preference items" that either are not included as income or are allowable deductions when filing your regular return. These major tax preference items that are of concern to farmers when calculating their minimum tax, are as follows:

a) the inclusion of the **one-half of the net capital gains** that are **non-taxable** for **regular tax purposes**
b) the disallowance of any Registered Retirement Savings Plan (RRSP) contributions
c) the disallowance of the $1,000 Interest Expense deduction and
d) the restriction of applying your Investment Tax Credits against the minimum tax payable
e) the non-deductibility of dividend tax credit for minimum tax. As a relieving feature, only the amount of dividends actually received is included as taxable income, and not the gross-up amount.

There is one very important feature of the Alternative Minimum Tax, however, that must be understood by all taxpayers. If the minimum tax exceeds your regular tax payable in any particular year, this excess can be carried forward for up to seven years and applied to those subsequent years when the regular tax payable exceeds the minimum tax. For example, if the minimum tax is $5,000 in 1987, and your regular tax is calculated to be only $3,000, this excess of $2,000 can be applied to any subsequent year's tax liability, assuming at least $2,000 regular tax payable over and above any minimum tax due. This carry-forward feature combined with the $500,000 Lifetime Capital Gains Exemption (which will be discussed later in the publication) results in most farmers still being able to liquidate their capital property (land, buildings, corporate shares and partnership interests) without incurring a tax liability.

*It is important to note that at present **NO** such minimum tax calculation is required by corporations.*

FACTORS IN CONSIDERING FARM INCORPORATION

In many instances, farm business arrangements are made primarily to reduce the yearly tax bill. Some of the income tax advantages and disadvantages to incorporation are discussed later.

The goals, objectives and the interpersonal relationships of the members within the arrangement are often ignored. Since farming involves an intimate connection between business and the personal, failing to consider the personal element could prove disastrous.

The success of any business arrangement depends heavily on harmonious personal relationships. If two parties cannot get along before working together, they are not likely to get along after signing an agreement. Their goals and values must be compatible enough that they have a common bond in making the business a success. Also, a successful business arrangement requires that the business generate enough income to maintain all the members. Dissatisfaction is inevitable if the total earnings are too low.

In deciding the type of arrangement best suited to your own situation, recognize the time frame involved. For instance, if incorporation is to be considered, remember that **this is a long term arrangement.** Upon dissolution, the company will have to sell all its assets to outside parties or to individual shareholders at their fair market value, making the potential tax costs enormous. This topic will be covered in greater detail in the section on tax planning.

Although many complex factors affect the success of any business arrangement, the combination of open communication, a willingness to cooperate, sound legal advice and simple common sense go a long way toward making it successful.

LIMITED LIABILITY

One of the features of a company that is often referred to but rarely understood is limited liability. Shareholders' liability is limited to the amount they have invested or are committed to invest in the company.

For example, assume Happy Farmers Incorporated has issued 10,000 shares for $1 each at the time of incorporation. Mr. Arnold and his son John have purchased these shares for $10,000 and have since borrowed $10,000 from the company. Shortly thereafter, Happy Farmers was forced into bankruptcy. The company sold its assets and received $100,000 in cash but the liabilities totalled $140,000. For what are Mr. Arnold and his son John liable?

After liquidation, the company experienced a $40,000 deficit (assets $100,000 less liabilities $140,000). Since Mr. Arnold and John still owed the company $10,000 (the amount borrowed) their personal liability is restricted to $20,000 (their original $10,000 investment in shares plus the $10,000 owing). The creditors will have to settle for $110,000 of cash which works out to a settlement of 78¢ on the dollar owed.

Any business which contemplates entering into a contract with a limited company is warned of the form of organization by the words "Limited, Corporation or Incorporated" or their abbreviations "Ltd., Corp. or Inc." in the name of the company.

Lending institutions usually require the directors to personally guarantee payment of the company debts if the corporation has insufficient equity. This can eliminate many of the **so-called advantages** of limited liability.

How beneficial is the limited liability feature to farm families where they transfer most of their assets to the company? In such a situation all their assets, the value of which is represented by shares and debt in the company, would be placed at the full risk of the business, and the advantage usually attributed to the limited liability feature might well be lost.

Limited liability could be advantageous to retiring farmers who only want to keep a portion of their assets invested in the farm business. The property outside the company could be protected and remain free from any liabilities incurred by the company. Farm operators who have considerable outside farm investments would also most likely find the limited liability feature very advantageous. Even though they transfer assets to the farm company in return for shares, their other interests are protected by the limited liability feature.

As well as creditor liability, liabilities from law-suits can also jeopardize the farm business. Assume, for example, a company employee on farm business is found negligent in a school bus accident in which 20 children are seriously injured. The employee and the employing company could be sued for an enormous sum. In this situation, shareholders' assets held outside the company would be protected from the lawsuit. On the other hand, a company is not liable for the personal debts and obligations of its shareholders. This can be a distinct advantage over other forms of business arrangements.

It is evident that the limited liability feature may be somewhat overrated and farmers should proceed cautiously if incorporation is sought for that reason alone.

REMEMBER: *The limited liability of a shareholder with regard to a specific debt is eliminated when a personal guarantee is given to a creditor of the company.*

FARM BUSINESS CONTINUITY

An advantage of the company form of organization is continuity or permanence. A company has a perpetual existence and can exist as long as the shareholders want to keep it operating and it continues to meet the requirements of the legislation under which it is incorporated. Theoretically it provides a means of keeping the farm business operating and avoids many of the problems that develop at the death of a sole proprietor.

In practice, the loss of the principal shareholder may have a powerful impact on the continued operation of the farm business. A "one-man" farm company or a farm company which has no definite plans for handing over the reins to a capable manager has no real permanence. This makes it important to consider what will be done with the company after the principal shareholder is gone. It may be that a child will acquire the shares by will. If no child has come into the company, the shares of the principal shareholder will generally be left to the spouse.

Continuity of business may be a disadvantage to minority shareholders in a farm company unless proper steps are taken to safeguard them. A minority shareholder, one owning less than 50 per cent of the voting shares, is not in a position to cash in shares or force payments of dividends on these shares. This can effectively "lock in" the shareholders to realize no return on their investment.

Generally, the transfer or sale of shares can be done only with the approval of the directors in a small corporation. The articles of incorporation or a separate shareholders' agreement should therefore be carefully drafted and spell out in detail the method to follow for buying out the shareholders who wish to sell.

REMEMBER: *A minority shareholder should have a clear understanding of his/her position before agreeing to enter into a company.*

POOLING OF RESOURCES

There is a definite economic advantage to the pooling of land, labor and capital. But effective management is required to utilize these resources efficiently. For instance, if farm equipment is replaced with larger machines requiring less fuel and labor, this will result in reduced operating costs but may not make the best use of the farm workers available.

Groups commonly find it difficult to make optimum use of the extra manpower that usually results from pooling resources. However, as participants may have varied skills these can be used to enhance the business. Proper use of manpower and management will result in greater productivity and a satisfactory social atmosphere. In the U.S., one common example of pooling resources is where a number of grain producers incorporate hog feeder operations. Each producer becomes a shareholder and sells grain to the company as feed. This produces an assured market for grain and the producers may obtain dividends if the company prospers. They can also diversify their operations on this basis.

If pooling of resources appears desirable, one advantage of using a corporate structure is that it is sometimes easier to obtain capital. A company has some assurance of perpetual operation, is required to prepare annual financial statements and is more unified and business-like. Furthermore, the personal liabilities of individual owners or shareholders do not jeopardize the business.

REMEMBER: *Any group considering incorporation should spend a considerable amount of*

time planning the type of enterprise(s) they should operate, and outline the responsibility of each member.

COST OF ESTABLISHMENT

Incorporation definitely involves a more complicated business structure than other forms of business arrangements. It requires separate financial statements and income tax returns for the company which must generally be prepared by qualified accountants. This adds to the tasks of the farmer who must keep adequate records in order that the company avoid problems under the Income Tax Act.

Significant start-up costs and annual operating costs are associated with incorporation. The provincial government charges a fee of $200 for incorporation. Legal fees for incorporation will generally cost at least $500, including the preparation of the required documentation such as the articles of incorporation, the by-laws and the incorporating minutes. Transferring property to the corporation will also involve legal and accounting expenses as will such special arrangements as shareholder agreements and deferred profit sharing plans. Legal fees will therefore vary depending on the nature and complexity of the business and the corporate structure. These fees should be discussed with the lawyer **before proceeding with incorporation**.

TAX PLANNING

THE $500,000 LIFETIME CAPITAL GAINS EXEMPTION

On May 23, 1985 a new set of rules regarding Capital Gains was introduced to the Canadian tax system. The intent was, according to Finance Minister Wilson, to "encourage risk taking in investment in small or large businesses and to assist farmers by providing a cumulative tax exemption for capital gains up to a lifetime of $500,000". It is very important to understand that the $500,000 capital gains exemption is available only to **individuals** and not to **corporations**.

The exemption will generally apply to all capital property owned by an individual such as farmland, buildings, machinery, partnership interests, and **corporate shares**.

For corporate shares to qualify as "qualified farm property", the corporation must be actively engaged in the business of farming at the time that the sale of the shares takes place. This is in contradiction to the situation of an individual farmer who wishes to sell his land and buildings. If that individual or his family had farmed the land for any five-year period, he can qualify for the $500,000 exemption even though he is not farming the property at the time of disposition.

For further clarification on this topic regarding the $500,000 capital gains exemption, please refer to pages 22 through 24 in Tax Management Strategies For Alberta Farmers, Agdex 837.

Remember, Corporations are not eligible for the $500,000 Capital Gains Exemption and thus must pay tax on a disposition of capital property without reference to the exemption.

The corporation, as mentioned earlier, is considered in law to be a separate taxpayer from the person who controls it. The importance of this fact is that the rate of tax for a corporation in Alberta with active business income qualifying for the small business deduction is 20 per cent whereas the top rate of tax for an individual is 48.8 per cent (subject to additional surtaxes). Properly used, a corporation may offer the following tax advantages under the proper circumstances:

- accumulation of capital for investment in the corporation at low rates of tax
- income splitting among family members through payment of salaries and dividends
- offers an opportunity to choose a different fiscal year end for your business
- reduction of tax on income that flows through a corporation.

THIS SECTION HAS BEEN DESIGNED TO ACQUAINT THE READER WITH SOME OF THE BASIC TERMINOLOGY AS WELL AS THE CONCEPT USED IN CORPORATE TAX PLANNING.

TAXATION RATES ON BUSINESS INCOME

The public corporation is generally what most people think of when they hear the word "company". Generally, a public corporation is a company resident in Canada which has its shares listed on a prescribed stock exchange in Canada. Alberta Energy Company Ltd. and General Motors of Canada are examples of public corporations.

Farming corporations are almost always considered to be "private corporations". A private corporation must be resident in Canada with fewer than 50 shareholders and must not advertise its shares for sale.

The taxation of public companies and their shareholders is rather straight forward. All income including taxable capital gain is taxed at the **basic federal corporate rate of 46 per cent**. The federal tax is then reduced by an amount equal to 10 per cent of the taxable income earned in that year. This is termed the **federal tax abatement**.

The provinces then apply their own tax which varies from province to province and also with the type of corporate income imvolved.

Consider, for example, the following tax situation for an imaginary public company:

Taxable Income	$100,000
Federal Tax @ 46% of taxable income	$ 46,000
Less Federal Tax Abatement @ 10%	10,000
Net Federal Tax	$ 36,000
Add Provincial Tax @ 11% of taxable income	11,000
TOTAL TAX PAYABLE	$ 47,000

$$\text{Tax Rate} = \frac{\text{Tax Payable}}{\text{Taxable Income}} = \frac{47{,}000}{100{,}000} = 47\%$$

In a private corporation, the same tax rules apply unless the company is a Canadian controlled private corporation and can qualify for a **small business deduction**. A Canadian controlled private corporation must have one or more shareholders living in Canada who collectively retain at least 50 per cent control. In addition, it must not advertise its shares for sale. Most farm companies will fall into this category because the owner of the most voting shares is usually the operator and resides on or near the farm. The small business deduction IS A REDUCTION OF UP TO 21 per cent FROM THE FEDERAL TAX OTHERWISE PAYABLE. Furthermore, the provincial corporate rate in Alberta for a small business corporation is 5 per cent. The impact of qualifying for the small business deduction is illustrated by expanding the previous example.

Taxable Income	$100,000
Federal Tax @ 46%	$ 46,000
Less Federal Tax Abatement @ 10%	10,000
	$ 36,000
Small Business Deduction @ 21%	21,000
Net Federal Tax	$ 15,000
Plus Provincial Tax @ 5%	5,000
Total Tax Payable	$ 20,000

$$\text{Tax Rate} = \frac{\text{Tax Payable}}{\text{Taxable Income}} = \frac{\$\,20{,}000}{100{,}000} = 20\%$$

The difference in total income tax payable between a company that qualified for the small business deduction and one which doesn't, each with $100,000 of taxable income, is $27,000. Without the small business deduction, the corporate tax rate for farmers in Alberta is 47 per cent; with the deduction it is 20 per cent.

Eligibility for this deduction depends not only on being classified as a Canadian controlled private corporation but also upon the level of taxable income generated each year. If the annual taxable income of the company (after expenses, including salaries) **is less than $200,000.**

TAXATION OF INVESTMENT INCOME

The common belief that investment income is taxed at the same rate as ordinary income in a corporation is incorrect. The taxation of investment income which includes interest, the taxable portion of capital gains, rental payments, and royalties are not eligible for the small business deduction and are therefore taxed at a higher rate. The rate for investment income in Alberta is 47 per cent. This applies to all levels of investment income, be it $1 or $1,000,000.

If a company which has earned sufficient investment income decides to declare a taxable dividend to its shareholders, the company will receive a refund equal to 16 2/3 per cent of the investment income. Its net tax on investment income will therefore be reduced to 30 1/3 per cent. This refund is defined as a **refundable dividend tax credit.** To illustrate this procedure, assume the following:

Corporation A decided to sell a half section of land to a neighbor for $162,000. The adjusted cost base (ACB) of the property is $32,000 resulting in a capital gain of $130,000 of which one-half ($65,000) is taxable.

COMPANY A

Investment Income	$162,000
Taxable Capital Gain	$ 65,000
Federal and Provincial Tax (65,000 @ 47%)	$ 30,550
Balance of After Tax Income	$ 34,450
Tax Exempt Portion (ACB Value)	$ 32,000
Non-Taxable Capital Gain	$ 65,000
Net After Tax Income	**$131,450**

Balance Check

Tax Payable	+	Net After Tax	=	Sale Proceeds
$30,550	+	$131,450	=	$162,000

In the sale of a capital asset, only one-half the capital gain is taxed. The untaxable portion of capital gain ($65,000) and the tax free base ($32,000) can be distributed to the shareholders as a **capital dividend** tax free. What about the 16 2/3 per cent taxable refund?

To reduce the tax rate from 47 per cent to 30 1/3 per cent the company has to declare **taxable dividends of $65,000.** This reduces the corporate tax bill from $30,550 to $19,717.

In an effort to further reduce the tax impact of a capital sale, it may be prudent tax planning to create a corporate loss in order to have the loss offset the investment income. As the majority of corporate farmers file on the cash basis, this cash loss can be accomplished, for example, by increasing the purchase of inventory such as cattle in the year that a disposition of capital property occurs.

The result is that the corporate loss is applied to the investment income and thus shelters this income from the high rate of tax. In the subsequent year, when the "extra inventory" is sold, the increased income will be taxed as business income, subject to the 20 per cent rate, rather than the potentially 47 per cent rate on investment income.

TAXATION OF DIVIDENDS

For income tax purposes, the word "dividend" can generally be taken as a share of the profits of a corporation distributed to its shareholders. As indicated in the section Distribution of Profits and Losses, there are two applications of tax, one at the company level and one at the individual level. It appears that the small business corporate tax rate of 20 per cent plus the rate on salaries and dividends received would soon combine to place you in a higher income tax bracket than you would be in as an individual. This presumption is not necessarily valid as taxable dividends **receive a dividend tax credit which is deductible from federal tax payable.** Consider the following example:

	Income earned through corporation	Income earned directly (individual)
Corporation		
Active business income	$15,000	
Corporate tax, 20%	3,000	
Dividend Distribution	$12,000	
Individual		
Dividend	$12,000	
Gross-up	4,000	
Total Taxable Income	16,000	$15,000
Tax thereon	2,826	
Dividend tax credit	2,666	
Net Income Tax (personal)	160[1]	3,698
Cash retained by individual	$11,840	$11,302

[1] Depending on the level of personal earnings an AMT calculation may be necessary.

Note: To simplify the illustration, all exemptions have been ignored.

It may not be good planning to only receive dividends, as a salary/dividend mix may allow you to participate in pension and income deferral schemes which are based upon salary income. A good accountant will prove invaluable in evaluating your situation and will indicate the most desirable profit allocation alternative.

INCOME SPLITTING

Income splitting may be achieved in a number of ways. One method is the payment of salaries to the various family members involved. Of course, salaries must be reasonable for the services rendered.

A second and related method involves issuing shares in a new corporation to a spouse and/or children. If the company is successful, the profits will be split in the form of dividends among family members who are shareholders.

There are some pitfalls in having a group of family members as shareholders. Your ability to deal with the company effectively may be reduced, especially if there is a dispute among shareholders. The issuing of shares is irreversible unless the company can repurchase these shares from the shareholder. In this regard, it is prudent to have shareholders agreements among family members outlining the rules for the sale or repurchase of shares.

In light of the various factors which have an effect upon the determination of how much to pay family members and the character of such payment (i.e., salary vs. dividends) it is now highly recommended that you work out a plan with your financial adviser.

OTHER TAX CONSIDERATIONS INCLUDE:

- A corporation is not permitted to use the five-year block average or forward averaging, as it enjoys the flat tax rate of 20 per cent on active business income.
- If an individual has personal use of a company car or a house, then the value is attached to this benefit must become taxable income to the individual.
- Loans from a corporation are dealt with in a very restrictive and specific manner by Revenue Canada. If a shareholder receives a low interest rate loan from the corporation he or she may be deemed to have received a taxable benefit. This occurs if the interest rate charged is less than the prescribed rate (9 per cent) in 1987. Only taxable benefits in excess of $500 are taxable.

If a shareholder is receiving a loan to purchase fully paid shares of the corporation, the interest benefit is exempted. Any remaining unpaid balance owing to the corporation at the end of the following year will be deemed income to the shareholder, unless the loan has been for the purchase of shares, purchase of a house, or automobile.

TRANSFERRING PROPERTY TO THE COMPANY

The general rule of the transfer of property to a corporation is that the transfer must take place at the fair market value of the property. This may result in capital gains on the sale of capital assets, recaptured capital cost allowance or capital gains on the sale of depreciable assets and income from the sale of inventory. If both the transferor (the farmer) and the transferee (the corporation) make a **joint election** on the transfer price, on a timely basis, it is possible for some or all of the tax which would otherwise arise to be deferred. This deferral is commonly referred to

as a "Section 85 rollover". The following questions and answers will explain how to arrive at the proper elected value to defer any tax.

a) At what value should land and machinery be transferred into a company?

If it is your intention to defer capital gains payable, the land should be transferred in at its V-day value (December 31, 1971) or its cost if purchased after V-day (adjusted cost base). Depreciable assets such as buildings and machinery should be rolled in at their undepreciated capital cost - approximately what they're worth on your books at the time. Any assets you still might have on the straight line depreciation method should be rolled in at the higher of their original cost or their V-day value, but not greater than their fair market value.

b) How do I transfer inventory to a company without creating any income in my hands?

Inventory can be transferred in at its tax value (usually $1.00). Let's take cattle as an example. The company would acquire the cattle at a cost base of zero and you would receive no cash from the transfer. You may wish to claim on your personal tax return any expenses incurred (purchases, feed, vet, etc.) before transfer of the asset if you have other farm income to offset such expenses.

For example, assume the cattle have associated costs as follows:

feed	$1000
veterinary supplies	200
other	800
TOTAL	$2000

A farmer may wish to incur these costs directly before the cattle are transferred to a company. By incurring these costs, the individual would incur an income tax deductible expense but any income from the sale of the cattle after being transferred to the company would be income to the company.

c) It seems that to defer tax on inventory transfers, I must gift the assets to the company free of charge. Is that true?

No. A sales agreement can be negotiated whereby you receive payments over time with or without interest. The payments are taxable in your hands and deductible to the company provided both parties are filing on the cash basis. An alternative is to take back more shares. If an estate freeze is your objective, receiving retractable preferred stock would be advisable. On the other hand, common stock will allow you to contribute to the company's start-up assets and participate in its future growth.

d) Is it always advisable to have a complete **rollover** of property into a corporation?

No. Often it is advantageous for an individual to create some tax liability when transferring assets. This method makes use of any exemptions or deductions that the transferor may have. Unless a capital gain or income is created, a farmer who has any capital losses or net farm operating losses will lose these deductible expenses.

It is imperative that an individual look at his situation and decide if a capital gain should be triggered rather than a rollover when capital property is transferred to a corporation to take advantage of the $500,000 capital gains exemption.

This sale could be structured under an agreement for sale over a certain term of years, with or without interest. The result would be a capital gain to the individual with the corporation receiving land with a high Adjusted Cost Base. By having the sale structured over time, a capital gains reserve is created and this offsets the impact of the Alternative Minimum Tax. On the other hand, buildings and depreciable property such as equipment, should probably be rolled into the corporation at their undepreciated capital cost value in order not to create recaptured capital cost allowance (RCCA), which is fully taxable as income.

NOTE: This strategy of claiming a capital gains reserve is available if the corporation is not controlled directly or indirectly by the taxpayers who sell the land to the corporation. In other words, a farmer who owns the land cannot sell the land under a capital gains reserve to his company unless his share of the voting shares is 50 per cent or less. If the alternative minimum tax is not a concern, or you have decided that the carry-forward feature of minimum tax offsets the disadvantage of paying mimimum tax, then this caveat can be ignored as the reserve is not necessary.

This sale strategy will result in the individual receiving income from the corporation on repayment of debt and thus incur a very low tax liability (due to the $500,000 exemption) and result in the corporation being able to distribute 80¢ dollars to the farmer to pay for the equity that the farmer already owns individually. Furthermore, if the farmer happens to die prior to the corporation paying off this debt, he can in his will forgive the debt (no tax consequences), or this debt can be left to non-farm children under certain terms and conditions. This leaves the farming child in control of the company but gives your estate planning flexibility to make things equitable for your off-farm children.

e) Can my existing Livestock Inventory Provision (L.I.P.) be transferred to a company along with my cattle?

No. Your L.I.P. will cease to exist once the cattle are transferred. The company may, however, be able to create its own. For example, assume the following: Mr. Brown, on the advice of his accountant, decided to incorporate his farm on May 1, 1987. Up to that point

he had generated $50,000 of income but had paid for most of 1987's expenses which totalled $45,000.

In 1986, Mr. Brown had purchased $40,000 worth of steers creating a net farm loss of $25,000. His accountant advised him at that time to add $30,000 of artificial income using the Livestock Inventory Provision. This resulted in a final net farm income of only $5,000 which was offset by his personal deduction. His personal tax position at May 1, 1987 is as follows:

Income	$50,000	
Expenses	45,000	
Net Income	5,000	
Subtract LIP	(30,000)	-carry forward from 1986
Net Income	(25,000)	
Cattle Sale[1]	25,000	
Personal Taxable Income	NIL	

[1] transfer steers to company for $25,000

The farm income incurred up to May 1, 1987 is taxable in the hands of Mr. Brown. After that date, earnings of the farm will be reported by the company; therefore, the accountant advised Mr. Brown not to transfer the steers into the company on a tax free basis but rather sell them for at least $25,000. This $25,000 will be added to his farm income as a sole proprietor but a negative net income of $25,000 exists, and no taxable liability would result. The company on the other hand, has a deductible expense of $25,000 which will be applied when it ultimately sells the cattle.

f) How about a basic herd?

A pre-1972 basic herd cannot be rolled over into a corporation because the concept of a basic herd is being phased out. The procedure for transferring the basic herd is as follows:

- the herd could be transferred to the company for the **basic herd** amount, triggering no tax liability. This value is the average fair market value as of December 31, 1971. For example, if in 1971 you had 100 cows in your basic herd valued at $280 per head, the elected transfer value would be $28,000 even if the herd's present value is $80,000.
- If some tax liability is advantageous, elect a value greater than the $280 per head. The elected value should be high enough to generate sufficient income to offset any exemptions or deductions.

g) Can I transfer my principal resident status on my house into a company?

No. If the principal residence, which includes the farm home plus one acre of land or more (if it contributes to the use and enjoyment of the home as residence), is transferred to a corporation, it no longer qualified for the exemption applicable to principal residences. The present fair market value of the principal residence can be transferred to the company tax free. Any future capital gain upon the sale of the residence will be subject to tax in the company. If the farm home is owned by the company, the expenses on the home such as the mortgage interest, the property tax, and some capital cost allowance can be deducted. To justify these expenses and to avoid taxable benefits to the farmer, the company should charge the farm shareholder a reasonable rent for the family's use and occupation of the residence.

In certain cases it may be feasible to have a legal subdivision of the land containing the farm home. If this can be done, the principal residence may be kept in the hands of the individual and maintain its tax-free classification.

h) How about my liabilities?

Some or all the debt of the farmer may be assumed by the corporation. Normally the assumption of debt is part of the non-share consideration. The only area of concern is where a corporation assumes the debt that is greater than the adjusted cost base (ACB) and the undepreciated capital cost (UCC) of the capital assets transferred into the corporation, or where the debt on inventory is assumed. On the assumption of a capital debt, capital gains or recaptured capital cost allowance can be triggered and on the assumption of debt on inventory, (cattle), taxable income is triggered. As this area is quite complex, a qualified adviser should be consulted before a corporation is initiated, especially to ensure that debt being transferred to the corporation does not remain a contingent liability to the transferor.

ESTATE PLANNING

Besides obvious income tax advantages, farmers are considering incorporation as a method of preserving and transferring the family farm to the next generation. Most farmers are eventually faced with the question of how to be fair to their children yet maintain an economical unit for those interested in farming. A corporation can make this transfer of ownership and retirement planning easier and less complicated.

If the farm unit is of the scale that two or more of the family members are planning to farm on their own, then the distribution of assets from parent to child may result in distinctly uneconomical units. For instance, the smallest parcel of land that can be transferred (unless subdivided) is a quarter section.

A corporation allows a farm unit to remain economical with the participation of a number of individuals. It also allows a farmer to transfer ownership, participation and control in very minute amounts (i.e. shares) according to his estate plan.

A corporate structure will not guarantee that the farming heirs will remain together. But since a company has formal rules of ownership, control and distribution of profits and management, success is more likely. Another advantage is that since the company owns the property, one son will not, for example, receive a better quarter of land or newer equipment than the other. This helps eliminate the problem of unfair distribution of production assets.

Family members not interested in farming per se still might wish to remain part of the family farm. Most parents do not wish to become only creditors with little or no input into the family business. In a sole proprietorship where assets are sold or gifted, control, which is also part and parcel of the purchase price, is relinquished. The section on capital structure discussed the various types of shares that allow a minority shareholder to own a small portion of the business. Depending upon characteristics of the shares, nonactive family members can either redeem their shares for cash, receive dividends or perhaps even participate in the growth of the company.

WHAT ARE THE BENEFITS TO THE PARENTS?

Security in retirement is perhaps one of the best features a company offers. The parents have the option of when to transfer voting control, when to call in any redeemable shares or notes for retirement income and if they wish, still participate in the future growth of the company.

One major problem facing companies is also one of its advantages - the primary feature of the business arrangement being permanent. Under the section Farm Business Continuity, we find that a company has perpetual existence and that it is treated as a separate legal "person". When a company is dissolved or wound up, the "person" dies and all assets are deemed sold at their fair market value. The rule is simple: **when assets are transferred into a company there is a deferral of tax**. When assets are withdrawn from the company and distributed to the shareholders, **any capital gain, ordinary income, or recaptured capital cost allowance is realized and taxed as if sold for fair market value without the benefit of the $500,000 capital gains exemption.**

TRANSFER OF SHARES

Until recently one major disadvantage of incorporating a farm was the inability to transfer shares in a company from parent to child. The Income Tax Act now allows the tax deferral transfer (rollover) of shares in (a) a **family farm corporation** from a parent to a child if (b) **substantially all of the assets** of the corporation are (c) **used in the business of farming** and (d) **any one of the children or parents are actively engaged** in the farm business carried on by the company. This transfer can be either upon death via a will or while the farmer is still alive (i.e. inter vivos). For a rollover to apply, the child who is receiving the shares (e) **must be a resident in Canada immediately before the transfer takes place**. What are some of the major considerations of this amendment?

a) **Family Farm Corporation** - To qualify, the corporation must be a Canadian controlled private company. The requirements for this classification were discussed in the section under taxation rates. The main requirement is that the corporation has at least one or more shareholders with 50 per cent control living in Canada.

   This rarely poses a problem except if the parents retire outside Canada. For instance, if the parents decide to live in Arizona for the better part of the year, they may lose their right to the rollover provision. It is very important to consult with an accountant and/or lawyer before you decide to retire in another country.

b) **Substantially all of the assets** - What determines "substantially" has not been defined. It is advisable that any major off-farm investment be held in the name of the shareholders and not the company. A second investment company should be considered if these holdings are significant.

c) **Used in the business of farming** - taken as a general statement, no farmer should be concerned about this stipulation. But in the case of custom farm operators, their businesses are not classified as farm operations.

   A strict interpretation of the provision would mean that farmers who do custom work are ineligible for the rollover provision. **This is not the case**, as the word substantially (as in (b) above) must be considered.

Revenue Canada has not published any definite guidelines on this point, but it appears in practice that if your company does some custom work the rollover provision will still remain intact. As this is a grey area, consultation with a financial adviser is highly recommended.

d) **Any one of the parents or children actively engaged** - Two common misconceptions concerning the rollover position are that the father and son must both farm the land and that the rollover of shares can only be to the children actively farming. Both are in error.

   Only one family member needs to farm the land. It can be father, mother or child. If only one child farms the land, company shares can still be transferred from the parent to nonfarming children free of tax. The definition of child includes: grandchild, greatgrandchild, daughters and sons-in-law, adopted children and dependent individuals under the age of 21.

e) **Must be resident in Canada before the transfer** - If you were to transfer any shares to any children while they were living outside Canada, tax officials would deem the transaction to take place a fair market value. Regardless of the actual transfer price you would be faced with capital gains tax, but the transfer of the shares would be eligible for the $500,000 exemption.

CONSIDERATION FOR SHARE TRANSFERS

The question that now arises, especially with the introduction of the $500,000 capital gains exemption, is what should I charge my children for the shares of my farm corporation? This question is of special importance in 1987, as a farmer can elect to transfer enough shares to utilize the **small business corporate rollover.** This provision allows a taxpayer to "roll" up to $200,000 in capital gains, accrued in shares of a Canadian controlled private corporation, to a child. The result is an elimination of any tax on the sale of these shares to a child, with the parents receiving $200,000 of proceeds. This is accomplished by leaving the adjusted cost base of the shares at the original value when acquired by the child. By using this technique in 1987, the $500,000 capital gains exemption has not been reduced and is still available.

The remaining shares could then be transferred under a rollover at fair market value or any value less than fair market down to the adjusted cost base of the shares. If the price exceeds the cost base of the shares, a capital gains is triggered, but is subject to the $500,000 exemption. In many situations an agreement for sale could be structured in order to utilize the $500,000 capital gains exemption and the capital gains reserves to offset the minimum tax implications. Furthermore, this debt becomes an asset to the seller and in his will can be forgiven in whole or in part or left to non-farm children under certain terms and conditions.

It is important to note, however, that if the proceeds to fund the buy/sell share agreement are to come from the corporation the child must receive the cash from the company in the form of either a salary or dividends, and this will attract a tax liability in the hands of the child. The other option therefore is to have the corporation redeem the shares, however, with new anti-avoidance rules dealing with corporate redemption of shares, the redemption of shares with a high paid up capital by a private corporation will result in a deemed dividend rather than capital gains. This effectively blocks the use of the $500,000 exemption in the case where a corporate redemption is considered.

Another concern of entering into buy/sell agreements on shares is the possibility that one shareholder involved in two or more corporations might, simply by entering into a buy/sell agreement, associate the two corporations, resulting in a common sharing of the 20 per cent small business tax rate up to $200,000 of collective net income. It is advised that an individual discuss other shareholdings with his adviser prior to entering into the buy/sell agreement.

If the $500,000 capital gains exemption is still in effect at the time of your death, the shares can be transferred to your children at fair market value by your executor. By electing not to have the rollover apply your children will get an Adjusted Cost Base bump on the shares up to the fair value elected by your executor. However, do not forget to look at the alternative minimum tax implications on this strategy as there may be an AMT applied to this bump. There is, however, a three-year carry-back of the Alternative Minimum Taxable Income over the previous three years of a deceased taxpayer's returns and this could nullify some of the AMT payable by the estate.

In counselling some farm families, we have found that the resulting minimum tax is sufficiently low that the beneficiaries of the shares have decided to pay the AMT tax liability in order to get the ACB bump on the shares.

LAND IN OR OUT?

When discussing whether to form a company or not, farmers always seem to pose the question, "Should I leave my land outside the company?" This is a very important question.

There are three major reasons why farmers hesitate to roll their land base into a company:

- **Pride of ownership** - Upon transfer of assets into a company individual ownership ceases to exist. This leads to a loss in the "pride of ownership" which has a high value in many individuals' minds.
- **Possible dissolution or re-organization of corporate assets** - Since there is no rollover of assets out of a company, the cost is enormous if dissolution occurs. Remember, all the assets are deemed sold back to the shareholders at fair market value regardless of the actual transfer price.

This concern with dissolution and reacquiring assets from a corporation is not so significant for taxpayers who have recently incorporated and elected to transfer their assets to the corporation at fair market value. If the land is ever withdrawn from the corporation, a large capital gains is unlikely, assuming land values do not increase substantially.

For other individuals it is possible to undertake a corporate reorganization whereby the assets of the existing corporation are transferred to two or more other corporations on a tax-deferred basis. This is termed a butterfly split, whereby one or more of the shareholders split their businesses and establish two or more independent corporations. The point to remember is that the assets will still have to be owned by a company and not by the individual to have the butterfly work. With the high cost of dissolution or taking assets out of a corporation, the decision to incoporate should only be made if the company is intended to have a long life.

- **Future generations** - The next generation always poses a hidden problem. For example, your sons John and Harry plan to form a company. What if one has two children and the other three? Can these children agree to work together and will they be satisfied with only pieces of paper representing their ownership in the farm? The best advice on this problem can be summarized as follows: **don't try to rule the farm from the grave.** Estate planning is difficult enough when trying to accommodate your children without projecting the needs and aspirations of future generations.

  The answer to these concerns depends on the individual situation. For each person to evaluate the pros and cons of leaving or putting land into the company, the following points should be considered:

- **Lease the land to the company** - This definitely solves the problem of loss of ownership control and if for whatever reason the company is dissolved, the land owners are not faced with a deemed sale and capital gains taxation.

  Because of a fairly recent amendment to the Income Tax Act, land that is being leased to a company now qualifies for the rollover provision as well as the $500,000 capital gains exemption. This amendment is very significant as this alleviates a major concern that farmers previously had when they decided to lease the land to a company and retain individual ownership.

- **Custom farm the land** - It is quite permissible to hire custom operators to do the farm work and maintain the rollover provision and qualify for the $500,000 exemption. The tax department visualizes that under a custom agreement, you are still making the decisions and thus actively farming. Regretfully, this arrangement has its drawbacks when dealing with the shares of that custom farm corporation.

  At times the earnings from the land may be substantially higher than the custom charges. This would lead to the farm earnings being taxed in the hands of the individuals rather than at the lower rate available to their company.

  Furthermore, if the company is considered to be a custom farm corporation, its business activities are not classified as farming.

In short, **the land is eligible for the rollover provision but the shares of the company may not be eligible** for a rollover except to the extent of the $200,000 small business corporate rollover.

These shares of your custom farm corporation will, however, qualify for the $500,000 exemption but will fall under the phase-in rules, whereas corporate farm shares qualify for the immediate $500,000 exemption.

In cases where livestock are a major enterprise, the company could still custom farm the land and receive enough income through livestock sales that it would still be classified as a farm corporation. By definition, substantially all of its assets would be used in the business of farming and not custom farming. This appears to solve the problem of not being able to transfer the shares under the rollover provision. while the landowners would still be faced with income arising from selling grain to the company, the majority of the income generated would be in the form of livestock sales and therefore corporate income.

REMEMBER: *Do not incorporate your farm solely to reduce your income tax bill. The problems of establishing common objectives, profit sharing schemes, and a workable arrangement concerning labor and management must be discussed and agreed upon first. The savings in your yearly income tax bill would be minute in comparison to your tax liability if the company is ever dissolved.*

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This example is intended to provide the reader with an overview of the considerations and procedures involved in establishing a farm corporation. It is hoped that the factual situation is fairly typical although many situations will arise which require special solutions. One such consideration in any business arrangement is the need for sufficient earnings to meet the requirements of each of the participants. As this varies considerably in each situation, this problem is not addressed in the following example.

SITUATION:

John Brown, age 45, has been farming for 15 years as a sole proprietor. He and his wife Mary, age 43, have three children: Bill, age 22, who is very active on the farm; Donna, age 17, who is interested in moving to the city to study medicine; and Bob, age 15, who is too young to know if he wants to work on the farm but talks about becoming an airline pilot some day.

Last year, Mr. Brown's taxable income was $40,000; tax paid was $12,863. Bill earned a wage which resulted in taxable income of $9,000 and $2,034 in tax. The farm is a mixed grain-livestock operation on two sections of land. Mr. Brown has been filing his tax return on a cash basis.

The financial statement prepared by their accountant shows the following assets and their values.

SUMMARY OF PROPERTY VALUES

ASSET	BOOK VALUE	VALUATION DAY	FAIR MARKET VALUE	ELECTED VALUES*
1. Land	$ 75,000	$125,000	$460,000	$125,000
2. Principal Residence	10,000	20,000	40,000	40,000
3. Buildings:				
a) Straight Line (Part XVII) Barn (built 1965) – $10,000	2,500	13,000	11,000	11,000
Cattle Shed (built 1968) – $2,000	900	7,000	5,000	5,000
Machine Shed (built 1970) – $4,000	1,600	10,000	9,000	9,000
	$ 5,000	$ 30,000	$ 25,000	$ 25,000
b) Declining Balance (Part XI) Class 6 (acquired after 1971)	$ 20,000	–	$ 25,000	$ 20,000
4. Equipment (acquired since 1971)				
a) Class 8 (original cost – $20,000)	15,000	–	30,000	15,000
b) Class 10 (original cost – $30,000)	25,000	–	70,000	25,000
5. Inventory (cattle, grain)	0	–	50,000	0
TOTAL	$150,000	$175,000	$700,000	$250,000

* These values must be the elected amount in order to have the assets transferred to the company on a tax deferral basis (rollover value).
It may be admissible for certain assets not to be "rolled" into a corporation but rather sold to take advantage of certain tax circumstances as explained in the section dealing with transfers of property.

FAMILY OBJECTIVES

The parents wish to remain actively farming and provide:

- for their retirement
- assistance to enable Bill to start farming, but yet maintain control of the farm assets
- some means of involving Donna and Bob in the farm business in the future but they feel that both are too young to have a direct involvement at this time
- some means to assist Donna and Bob in the future if neither chooses a farming career
- for a business arrangement that minimizes the tax liability both in the short and long term.

Bill wants to:

- become more active in the farming operation through the sharing of ownership and future growth of the farm business and have a greater voice in the farm decision-making
- have a steady income level which enables him to provide not only for living needs but also enough to purchase additional assets
- be given credit for prior contributions if other family members are brought into the business arrangement.

Having discussed the above with their regional farm economist (RFE), the family has decided to incorporate its farm business. The RFE assured them that a corporation could meet their objectives and also enable them to achieve certain income tax savings. As the required documentation for the transfer of assets and establishing the share structure and other legal arrangements are complex, the RFE recommended that they consult with both their accountant and lawyer.

TRANSFERRING THE FARM TO THE COMPANY

The accountant has advised the Browns that care must be taken in transferring the farm property to the company, otherwise tax may be prematurely triggered in Mr. Brown's hands. (See section on Property Transfers.)

The general rule for transferring property to a corporation is that the transfer must take place at the fair market value of the property. This may result in capital gains on the sale of capital assets, recaptured capital cost allowance and/or capital gains on the sale of depreciable assets and income from the sale of inventory. The accountant has outlined a number of exceptions to the general rule which apply to farmers and explained their implications in the transfer of Mr. Brown's assets.

An election pursuant to Section 85 of the **Income Tax Act** (Form T-2057) will have to be filed at the district taxation office to allow the property to be transferred to the company on a tax deferred basis. In each situation described below, the transfer value used resulted in no tax cost to Mr. Brown.

Deferral of Tax On Transfer:

Land - transfer at the adjusted cost base value (ACB)

In Mr. Brown's case the value of the property on December 31, 1971 (V-day value) was $125,000.

Principal Residence - transfer at the fair market value (FMV)

Upon sale of a principal residence capital gains are not taxable. In our example, we would transfer the principal residence to the company for $40,000 with no tax liability. Remember, once a home is transferred into a corporation, it loses its identity as a principal residence.

Depreciable Assets (Machinery and Buildings)

- Straight line assets - transfer at the higher of original cost or V-day value but not greater than fair market value. In our example the buildings would be transferred at $25,000.
- Declining balance asset - transfer at their undepreciated capital cost allowance value (UCC). Mr. Brown's assets were **depreciated** to a value of $40,000 which is the book value. After the property has been acquired by the company, it may carry on claiming depreciation as Mr. Brown did previously.
- Inventory - transfer at book value which is **zero** for a farmer filing on the cash basis.

SHARE STRUCTURE

A share structure must be chosen now that we have identified the property to be transferred into the company. The share structure should allow for maximum flexibility and for future distribution of the profits of the farm company.

The following table illustrates only one of many different share structure options available in the formation of a company. It is very important at this time to make sure that you have chosen a share structure that will allow you to fulfill your objectives and those of your family.

SHARE STRUCTURE - ALBERTA FARMS LTD.

FAMILY MEMBER	ASSETS (FMV)	NONSHARE CONSIDERATION	SHARE CAPITAL					
			PREFERRED (non voting)			COMMON (voting)		
			NO.	$ PER SHARE	TOTAL	NO.	$ PER SHARE	TOTAL
Mr. Brown	$700,000	$250,000	450	$1,000	$450,000	1500	$1	1500
Mrs. Brown	–	–	–	–	–	300	$1	300
Bill	–	–	–	–	–	200	$1	200
Donna	–	–	–	–	–	–	—	–
Bob	–	–	–	–	–	–	—	–

The share structure was selected for the following reasons:

- The father's net worth position is exactly the same as before incorporation. He has a promissory note (nonshare consideration) for $250,000 plus 450 preferred shares with a value of $450,000. Turning back to the table on property values, his net worth total is equal to this sum.
- By taking a shareholder's loan for up to the tax rollover value of the farm assets, the repayment of principal is not considered income to the lender. The company can claim any interest paid as deductible expense while Mr. Brown will only be faced with a tax liability on the interest received and not the principal payment.
- With preferred shares no tax is payable until the shares are redeemed or sold. When this occurs each share has the potential capital gain of $1,000 of which one-half is classified as taxable income. If so desired, these shares may be "rolled down" to family members with no tax obligation.
- What purpose do the common shares serve?
  - The common shares pass on future growth in the farm business to the participating shareholders. In addition, future rights to share in the profits by way of dividends will go along with these common shares.
  - Since the common shares have a voting power attached to them, they control the company. Family objectives can then be fulfilled by the distributing of these shares to family members. As in the case of preferred shares, common shares can be "rolled down" to family members with no tax being triggered.
  - With Mrs. Brown holding common shares, another tax advantage becomes available. Beside receiving a salary, she is entitled to dividends when declared by the company. This, as in the case of a salary, causes another **income split** and reduced taxes. Remember that Mrs. Brown must put in her own money for her 300 shares to avoid the possibility of income being attributed back to Mr. Brown for income tax purposes. In our example, she will need to invest $1 for each share from her own source of funds (family allowance is one available source). She should not obtain the funds from Mr. Brown in order to avoid the effect of the income attribution rules. If Mrs. Brown has acquired her shares with Mr. Brown's money, then pursuant to the attribution rule - Mr. Brown would be subject to tax on dividends paid to his wife.

HAVE THE FAMILY OBJECTIVES BEEN SATISFIED?

Mr. and Mrs. Brown's objectives:

- Mr. Brown has control of the company at its inception. This allows him to pass on shares to family members over time as he sees fit but yet retain voting control. Of course, in later years, this control can be passed on to those family members actively farming.
- His retirement security is guaranteed by both the note and the preferred shares. Should Mr. Brown desire funds before or during retirement these assets can be called upon to provide the necessary cash. Furthermore, Mr. Brown, as requested, still participates in the future growth of the farm business according to the number of common shares he retains.
- To assist Bill in his farming career, Mr. Brown can do the following:
  - the company employs Bill as a salaried employee and may set up various employment or stock option plans,
  - Mr. Brown may reward Bill by giving or selling shares in the company to him. These may be common or preferred, voting or non-voting depending on the priority and voting control Mr. Brown wishes Bill to receive.
- Should his other children be interested in farming, Mr. Brown has a sufficient number of shares that will allow him to assist them in exactly the same manner as he did Bill. If Donna or Bob are not interested in farming, then preferred shares can be gifted or sold

to them. If cash is required, or Donna and Bob do not wish to be shareholders of the company, Mr. Brown may call on his note and/or his preferred shares to provide cash for the non-farming children.

- Incorporation is the ideal vehicle for minimizing income taxes and providing flexibility in tax planning. In the short run these advantages are:
  - the special tax rate that applies to corporate earning and income splitting among family members which reduces the marginal rate of tax,
  - the ability to adjust the salary and dividend mix paid tc the shareholders,
  - greater use of certain employment benefit plans such as retirement allowances and group life insurance plans.
- In the long run a corporation offers a number of estate planning features, these being:
  - a tax deferred rollover of property to the corporation
  - Mr. Brown has the ability to transfer cash or assets to any of his children in minute parcels (shares) rather than selling or gifting ownership of each individual asset. This eliminates the breaking up of the family farm unit and provides a great deal of flexibility in estate planning
  - unlike a person, a corporation can live forever. This leads to permanence and avoids many of the problems that develop upon the death of a sole proprietor.

Bill's Objectives:

- By virtue of share ownership, Bill now has a vested interest in the operation and future growth of the business. He is now entitled to a voice in the decision-making process.
- By signing an employment agreement with the company, Bill has assured himself of a steady income which may be supplemented by director fees and/or dividends. This level of income would increase over time if Bill expands his share of the company. In addition, his future wife may be employed by the company, resulting in further tax savings.
- To provide credit for Bill's prior contributions and to eliminate future misunderstandings between the shareholders and to maintain a balance of control, the family members could have a shareholders agreement prepared which would contain various provisions such as:
  - buy-sell agreements in the event of disagreement or disputes
  - a provision entitling existing shareholders to proportional increases in their capital when new shares are issued or transferred (for example, Bob decides to enter the farm business and receives 100 common shares, Bill will be entitled to a further 100 as well)
  - a provision that shares may only be sold or gifted to family members. This maintains the farm as a family unit
  - if desired, provisions regarding life insurance policies and the use of farm assets such as automobiles and living accommodations may also be written into specific agreements.

Numerous other situations will require a different corporate structure. This example is only intended to give the reader an insight into the main considerations when forming a company and transferring farm assets into it.

BACKGROUND INFORMATION REQUIRED BY YOUR ACCOUNTANT AND LAWYER

To obtain sound advice from your accountant and lawyer, some prior organization and assembly of facts is advisable. The following checklist contains the items that most professional advisers find helpful:

1) A sketch or photograph of the physical layout of the farm showing the different parcels of land, location of buildings and the farm home will help your adviser obtain a mental picture of your farm.

2) A summary of the fair market value of all your farming assets on hand at the present time is essential. An independent appraiser is not necessary, but if a dispute arises with Revenue Canada, verification of your figures by an accredited appraiser may be necessary. In addition, a complete breakdown of all your liabilities must be provided.

3) If the farm was owned prior to December 31, 1971, then it is also necessary to have a complete listing of all the farm assets owned at that time, together with their original cost and an estimate of their fair market value at December 31, 1971 and at the present time.

4) For your adviser to assess your financial situation, personal tax returns and farm financial statements for as many previous years as you have them on hand would be useful. Budget projection for the current and future years would also be important.

5) In Alberta two companies cannot have the same registered name, therefore it is advisable to choose more than one name. If the name you choose is available, your lawyer will then reserve the use of

that name for a period of time until the corporation is established. If the name you choose is not available, another name can be searched for until a satisfactory name is found.

6) You should have a summary of your personal and financial goals as well as those of the other family members. As illustrated in the case study, members should list their objectives and see if the format of the proposed company meets their needs.

7) The decision of how ownership and control of the company is to be arranged is perhaps the most difficult task. Your advisers will outline the different share structures available but you will have to decide the type and number of shares to be issued and to whom.

   Other key items include the monthly cash flow requirements to meet living costs, your estate plans as to the future distribution of your assets, and your retirement plans. This information is vital if your accountant and lawyer are to properly structure the corporation and help plan future financial and tax strategies.

STEPS IN INCORPORATING THE FAMILY FARM

1) Obtain the opinion of people who have incorporated to get their ideas on the advantages and drawbacks of forming a farm company.

2) Avoid using do-it-yourself incorporation services and be wary of anyone offering incorporation for a cut rate. Inevitably, you will face legal and tax problems because of the improper formation of the company and its share structure. Serious tax consequences can arise if proper advice is not obtained before transferring any property to a corporation.

3) Discuss the benefits of incorporation with your accountant. The main concern of your accountant should be whether your farming business justifies incorporation.

   Once your company is formed and operating, your accountant should also determine the various ways of allocating company income, paying particular attention to salaries, rents and other deductible items. Income allocation will be important to shareholders who will not receive income as salaries, wages, rents or interest and who will want a return on their investment.

4) Obtain an estimate of the fees and disbursement costs associated with incorporating and what these fees cover before you proceed. Find out what additional legal follow-up services are most often required by families after incorporation.

5) Once the accountant has determined the tax aspects and income allocation, he/she will then work with your lawyer to ensure that the company is set up properly to accomplish your objectives. The accountant and the lawyer will jointly determine the financial structure. The lawyer will then draft the actual papers such as the articles of incorporation and the by-laws of the company in accordance with your needs. Only members of a farm company know what they expect the company to accomplish. You can also request that the lawyer draw up a unanimous shareholder agreement, profit sharing agreement or such other agreements as are desired.

6) If you decide to proceed with incorporation you will then have to choose a name for your farm company. Have your lawyer communicate with the Corporate Registry to see if this name is available for registration. There is currently a $25 fee for each search whether successful or not.

7) Duplicate copies of the articles of incorporation are then prepared and forwarded with the Notice of Registered Office to the Registrar of Corporations, Alberta Consumer and Corporate Affairs, Edmonton, Alberta; the fee for incorporation is $200, again, subject to amendment. The registrar will then issue a certificate of incorporation, if everything is in order, to show that the company is legally incorporated.

8) Your lawyer will then arrange for the following:
   - a meeting of the shareholders to elect a board of directors and to complete any necessary business
   - the minutes from the shareholders meeting
   - a directors meeting to organize the company (usually in the lawyer's office as he takes on the duty of preparing the shares, minutes and forms required)
   - the minutes from the directors organizational meeting.

9) The Corporate Registry sends a notice of appointment of directors form which must be completed and returned.

10) Your lawyer will maintain copies of the articles of incorporation as well as minutes of meetings of the shareholders and directors in the minute book.

    These records must be properly kept up-to-date and maintained at the registered office of the company which is usually your own home address.

WHAT REQUIREMENTS ARE NECESSARY ONCE THE CORPORATION IS OPERATING?

1) A good bookkeeping system is essential but need not be more complicated than one used by a well-run partnership or sole proprietorship. It is not necessary to use an accountant but it is wise to do so especially if one or more of the incorporators have not kept complete records of their business before incorporating.

2) The farm corporation must file a T-2 income tax return annually, rather than the T-1 general return used by sole proprietors and partnerships. The tax form for the company can be filed up to six months after the end of the company's business year, in contrast to the April 30 deadline for individuals. Revenue Canada allows income to be computed either on the cash or accrual basis for a farm business.

NOTE: *Liability for tax owing must be made within three (3) months of the year end and monthly installment payments are necessary.*

3) The shareholders of a company are required by law to hold an annual meeting of shareholders not later than eighteen (18) months after the date on which a company was incorporated, and then annual meetings must be held within fifteen (15) months from the preceding annual meeting.

4) A report must be filed annually with the Registrar of Corporations; the form to be used is supplied by the Corporate Registry. It generally includes such things as the name of the company, the registered office, the names, addresses and occupations of the directors and shareholders, and the summary of the number and type of shares transferred during the year. There is no fee for the filing of the annual report which is sent to the registrar. A private company is not required to file any financial statements with the registrar.

5) During the year, the Registrar of Corporations must be informed of any change in directors.

6) The address of the Corporate Registry and Registrar of Corporations in Alberta as at the time this publication is:

Alberta Consumer and Corporate Affairs
Corporate Registry
Century Place
9803 - 102A Avenue
EDMONTON, Alberta T5J 3A3

Alberta Consumer and Corporate Affairs
Corporate Registry
9th Floor, J.J. Bowlen Building
620 - 7th Avenue S.W.
Calgary, Alberta T2P 0Y8

7) Year-end Settlements and Shareholder Advances.
Advances to shareholders during the fiscal year of the corporation should be on a loan basis. On the last day of the fiscal year resolutions can be passed at a meeting which will indicate how the shareholder advances during the year are to be accounted for by way of dividends, wages, interest, or repayment of shareholder's loans. Deduction from the salary must be remitted to Revenue Canada by the fifteenth day of the following month.

8) Canadian Wheat Board.
Under the Canadian Wheat Board Act, only actual producers of grain are permitted to apply for a Canadian Wheat Board permit book to allow delivery and sale of grain. A corporation which has grain transferred to it by a shareholder may not apply for a permit book to sell the grain. To overcome this problem, the corporation and the person who transferred the grain to the corporation can enter into a marketing agreement for the remainder of the crop year, whereby the individual markets the grain on behalf of the corporation and assigns the grain cheques to the corporation.

After the corporation commences actual production, it is allowed to apply for a permit book. Only one permit book is permitted no matter how many shareholders are involved.

9) Prairie Grain Advance Payments Act.
Sole proprietors are limited to a $15,000 cash advance under The Prairie Grain Advance Payment Act. Corporations with two or more shareholders may apply up to a maximum cash advance of $45,000. Additional documentation is required when a corporation applies for a cash advance.

INCOME TAX ADVANTAGES VS. DISADVANTAGES TO INCORPORATION

Some Income Tax Advantages

Despite the number of significant commercial advantages to be gained from owning assets through a separate corporate entity, it is usually the tax savings and tax deferral aspects that have been the most compelling reasons for incorporating farm operations.

The two principal advantages to using a corporate structure stem from:

- preferential tax rates that apply within the company may result in a deferral of tax when earnings are retained in the company; and
- possible savings when the distribution of such earnings are made to the shareholders.

The above advantages can be further refined in order to provide some explanation of just how such advantages are obtained.

Combined Corporate and Personal Tax

In theory, the income tax laws have been drafted in such a manner as to make no material tax difference to business people owning their business personally or as a corporation. However, because Alberta has provincial income tax rates below those of other provinces, a taxpayer may still be able to minimize tax exposure by earning income within a company and establishing a proper dividend/salary mix rather than receiving revenue directly. (For example see below)

Income Splitting

Income splitting through a corporation is usually accomplished by having family members subscribe to shares in the company so that dividends can be paid by the corporation and taxed in their hands. There may be the opportunity to pay salaries to family members although this is also true without incorporation.

COMPARISON OF USE OF CORPORATION VS. EARNING INCOME DIRECTLY

Effective Income Tax Rates

	On Investment Income of $10,000	On Active Farm Income of $10,000
1. USE OF CORPORATION		
(a) tax payable by corporation:		
Amount of investment income	10,000	
Amount of farm income		10,000
Tax rate of 47% payable by corporation	4,700	
Tax at 20%		2,000
Balance retained by corporation	5,300	
Amount available to pay to shareholder as a dividend		8,000
Refund available to corporation upon payment of dividend	1,767	
Amount available to pay to shareholder as a dividend	7,067	
b) tax payable by shareholder:		
Dividend received by shareholder	7,067	8,000
Amount added to dividend to determine taxable income (dividend gross up)	2,355	2,666
Amount included in income	9,422	10,666
Federal tax payable on dividend (34% if maximum personal tax bracket)	3,203	3,627
Federal Dividend Tax Credit	(1,570)	(1,777)
Federal Taxes Payable	1,633	1,850
Provincial Taxes Payable (43.5% of Federal Taxes Payable	710	805
Personal Taxes Payable	2,343	2,655
c) COMBINED: corporate taxes	2,933	2,000
personal taxes	2,343	2,655
TOTAL TAX LIABILITY	5,276	4,655
2. INDIVIDUAL WITHOUT CORPORATION		
Amount of investment income	10,000	
Amount of farm income		10,000
Personal taxes payable (at combined 48.8% rate)	4,880	
Personal taxes payable (at combined 48.8% rate)		4,880
NET SAVING TO USE OF CORPORATION		
Net Income earned directly after taxes	5,120	
Net Income earned directly after taxes		5,120
Net Income earned after taxes through corporation	4,724	
Net Income earned after taxes through corporation		5,345
Net Saving	(396)	+225

NOTE: The above examples assume that the individual taxpayer is in the maximum income tax bracket and that the taxpayer has sufficient investment income from other sources to utilize the full $1,000 interest, dividend and capital gain deduction but that no minimum tax (AMT) is applicable.

Estate Freeze - Passing Future Growth On To Third Parties Using a company, you can hold shares with limited or no growth potential, while providing your spouse or your children with some or all of the shares which will accumulate future equity growth potential.

Restricted Farming Loss Rules - Where a taxpayer's chief source of income is "neither farming nor a combination of farming and some other source of income" the taxpayer's annual loss will be restricted to $2,500 plus one half of the excess loss, to a $5,000 maximum.

Farmers with high income from off-farm sources might be able to incorporate a farm and earn supplementary income to offset the loss without violating the chief source of income test, which requires that the nonfarming source of income is subordinate to farming income.

In appropriate circumstances, it may be possible to structure affairs so that the farming properties are in one corporate vehicle, while the individual shareholder bears deductible financial charges and other associated expenses.

Some Income Tax Disadvantages

Double Taxation Where Capital Losses Are Not Used
When an individual dies and does not leave his/her shares of a family corporation to a spouse or to a child, the general rule is that he/she is deemed to have disposed of all capital properties immediately prior to death. Generally the value of shares in a farming company will be based on the underlying business and assets of the corporation (this can create the first level of tax).

When the corporation subsequently disposes of the corporate owned property, it will recognize a capital gain which is the difference between the proceeds of disposition and the tax cost of the property (this can create the second level of tax).

Transferring Assets Out of a Corporation
While an individual may transfer assets to a corporation without incurring an immediate tax cost by making the appropriate income tax elections, such assets cannot be transferred out of a corporation to the individual except at the fair market value **without** the benefit of the **$500,000 Capital Gains Exemption.**

Loss of $1000 Interest, Dividend and Taxable Capital Gain Deduction
An individual taxpayer may deduct up to $1,000 of grossed up dividends and taxable capital gains from the disposition of Canadian securities. Generally the dividends must be from arm's length parties which excludes a corporation which the individual controls. As a result such income will become taxable in total.

Dissolution of Corporation
A corporation may be dissolved or wound up voluntarily or involuntarily. If it is wound up involuntarily, it may be as a result of being petitioned into bankruptcy under the Bankruptcy Act (Canada) or under certain provisions of The Business Corporations Act for failure to comply with certain requirements of The Business Corporations Act. The provisions for voluntary dissolution would be based on the corporation's bylaws or The Alberta Business Corporations Act. The corporation would sell its assets at fair market value and, in all likelihood, receive capital gain. Income tax is payable, the debts of the corporation are paid and the balance remaining is distributed to the shareholders as dividends.

The main cost in dissolving a farm company would be income tax since a large accrued capital gain normally exists on the land, recaptured capital cost allowance may occur on machinery, and the value of grain and livestock becomes taxable income. Conversely, if capital losses are incurred in disposing of the assets, the related tax advantages of such losses are lost forever.

If you plan to sell corporate assets to yourself or to other stockholders over time to reduce the tax liability, you must realize that this sale may cause Section 15 (2) "Shareholder Debt" to come into play. This section deals with situations when a shareholder has received a loan or has become indebted to his corporation. Unless this debt is paid off within one year from the end of the corporate year-end, the entire amount of the debt or value of the loan shall be included in computing the shareholder's income and taxed accordingly. In order to offset this rule perhaps a portion of your land could be sold each year and thus spread the proceeds over time. This will eliminate this problem of Section 15 (2). Remember, assets obtained from a corporation by a shareholder are deemed sold at fair market value.

It is strongly advised that your financial and legal adviser be consulted prior to dissolving a corporation, as there are several income tax and legal questions which must be considered before action is finalized.

The income tax considerations surrounding the decision to incorporate a farming operation are complex and are dependent on a variety of circumstances. Before making your decision to incorporate, make sure you have obtained competent professional counselling.

SHAREHOLDERS' RIGHTS AND REMEDIES

The Ongoing Decision Making Process

Where there is more than one shareholder in a corporation, the potential for conflict exists and with it the potential for abuse of the minority shareholders by those holding the majority of shares. The decision of the majority shareholders will generally prevail and there is nothing to prevent a majority shareholder from voting in his/her own interest without taking into account the general interest of the company as a whole.

Methods of Protecting the Minority Shareholders

Certain schemes have been adopted in the past which can be embodied into a shareholder agreement entered into by the shareholders of the corporation. Consideration should be given to creating a shareholder agreement which would provide minority shareholders protection. Such an agreement could include, among other things:

- a requirement that decisions be made by the unanimous consent of the shareholders
- a requirement that major decisions need more than simple majority. The Alberta Business Corporations Act spells out the need for a two-thirds majority in this regard, however, this can be increased through a shareholder agreement
- a right to have the minority shareholders' interest purchased by the company for fair compensation or to have certain shares acquired by other shareholders under certain circumstances
- the right to have the company wound-up and to have the assets distributed back to the shareholders on a pro-rata basis under certain circumstances.

Methods of Protecting the Minority Available Through The Courts

Inasmuch as the majority decisions continue to prevail for companies which are governed by The Alberta Business Corporations Act, if a minority shareholder has been treated unfairly, the court has the authority to make orders to rectify such unfairness.

Included in the remedies would be the following:

- the removal of directors of the company
- compulsory declaration of dividends payable to shareholders
- the setting aside of contracts which are of detriment to certain shareholders of the company.

In addition, the court now has a wide power to investigate the affairs of a corporation and to intervene on behalf of a minority shareholder or any other party which, in the discretion of the court, is a proper complainant.

Methods of protecting the minority provided by The Alberta Business Corporations Act

The Alberta Business Corporations Act continues to preserve the rights of majority rule for the day-to-day operations of the company in the absence of special agreements between shareholders to the contrary.

What The Alberta Business Corporations Act has done is to give special protection to minority shareholders where changes are being contemplated which are defined as being "fundamental changes" to the corporation. Included in the definition of fundamental changes are the following:

- amendments to the articles of incorporation to add, change or remove provisions restricting or constraining the issue or transfer of shares of that class
- amendments to the articles of incorporation to add, change or remove any restrictions on the business or businesses that the corporation may carry on
- amalgamation of the corporation with another corporation except under certain circumstances
- continuance of the corporation under the laws of another jurisdiction
- the sale, lease or exchange of all or substantially all of the corporation's property or
- amendments to the articles of incorporation which entitle the shareholder to vote separately on a special resolution pursuant to certain provisions of The Alberta Business Corporations Act.

Provided there is no other intervening agreement, The Alberta Business Corporations Act provides that the majority required to approve the fundamental changes referred to above is two-thirds (2/3) of the voting shares. However, shareholders holding shares with characteristics which would not otherwise entitle the shareholders to vote are entitled to vote as a separate group if that class of shareholders is specifically affected by the proposed fundamental change.

In addition to the voting requirements set out above, a shareholder dissenting from a ratified fundamental change may require the corporation to repurchase the shares held by the shareholder at a fair value of such shares. The determination of fair value may, in the absence of agreement between the parties, require a judicial decision.

In summary, where a fundamental change is contemplated by the company, minority shareholders and non-voting shareholders are protected in three ways:

- By providing non-voting shareholders with the right to vote

- By providing classes of shares with the right to vote separately as a group where such shareholders are specifically affected
- By providing dissenting shareholders who voice objection to the fundamental change with a right to have their shares reacquired by the company at a fair value.

CONCLUSION

The decision to enter into relationships with other parties through common investments of shares in a company is often rewarding. However, the decision has many pitfalls associated with it which should be understood before any commitment is made.

The use of special shareholder agreements or the careful drafting of rights attached to the shares which a party is buying can prevent a great deal of frustration and loss of money should the relationship between the parties degenerate in the future.

Obtaining competent advice as to your rights and obligations beforehand will generally help you not only to better utilize your corporation, but also to prevent you from encountering problems of a legal nature down the road.

SCHEDULE "A"

ALBERTA Consumer and Corporate Affairs

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1. NAME OF CORPORATION

_____ALBERTA LTD.

2. The classes and any maximum number of shares that the corporation is authorized to issue:

   (a) an unlimited number of Class "A" Voting Shares, which Shares shall carry and be subject to the following rights, privileges, restrictions and conditions:

      (i) to receive notice of and to vote at every meeting of the Shareholders of the Corporation;

      (ii) to receive such dividends as the Directors may from time to time by resolution declare;

      (iii) to share equally in the assets of the Corporation remaining upon the liquidation or winding-up of the Corporation with the holders of the Class "B" Non-Voting Shares and the Class "C" Non-Voting Shares on a share for share basis after the creditors of the Corporation and the holders of the Class "D" Preferred Shares have been satisfied;

   (b) an unlimited number of Class "B" Non-Voting Shares, the holders of which shall not be entitled to receive notice of or to vote at any meeting of the Shareholders of the Corporation unless otherwise provided by the Business Corporations Act and, in addition, the rights, privileges, restrictions and conditions attached to the Class "B" Non-Voting Shares are as follows:

      (i) to receive such dividends as the Directors may, from time to time, by Resolution declare;

      (ii) to share equally in the assets of the Corporation remaining upon the liquidation or winding-up of the Corporation with the holders of the Class "A" Voting Shares and the Class "C" Non-Voting Shares on a share for share basis after the creditors of the Corporation and the holders of the Class "D" Preferred Shares have been satisfied;

   (c) an unlimited number of Class "C" Non-Voting Shares, the holders of which shall not be entitled to receive notice of or to vote at any meeting of the Shareholders of the Corporation unless otherwise provided by the Business Corporations Act and, in addition, the rights, privileges, restrictions and conditions attached to the Class "C" Non-Voting Shares are as follows:

      (i) to receive such dividends as the Directors may, from time to time, by Resolution declare;

      (ii) to share equally in the assets of the Corporation remaining upon the liquidation or winding-up of the Corporation with the holders of the Class "A" Voting Shares and the Class "B" Non-Voting Shares on a share for share basis after the creditors of the Corporation and the holders of the Class "D" Preferred Shares have been satisfied;

   (d) an unlimited number of Class "D" Non-Voting Preferred Shares, the holders of which shall not be entitled to receive notice of or to vote at any meeting of the Shareholders of the Corporation unless otherwise provided by the Business Corporations Act and, in addition, the rights, privileges, restrictions and conditions attached to the Class "D" Preferred Shares are as follows:

      (i) the holders of the Class "D" Preferred Shares shall be entitled to receive out of the surplus or net profits of the Corporation, preferential dividends at a rate to be fixed by the Board of Directors from time to time, based on the stated capital allocated to the Class "D" Preferred Shares, in priority to any dividends payable to the Class "A", Class "B" and Class "C" Shareholders, in each year in which any dividend is declared. Such dividends shall be non-cumulative, so that under no circumstances shall dividends in excess of the amount fixed by the Board of Directors be payable in any fiscal year, except in the fiscal year of redemption or repurchase, to the holders of the Class "D" Preferred Shares and the dividends on the Class "D" Preferred Shares shall be paid only in each fiscal year in which a dividend is declared. In the event redemption is demanded by the holders of any or all Class "D" Preferred Shares, or if notice of redemption or repurchase of all or any part of the Class "D" Preferred Shares is given by the Corporation, all as hereinafter provided, dividends shall be declared by the Directors in an amount which shall be Eight (8%) percent per annum, calculated on the redemption or repurchase price, payable to the holders of the Class "D" Preferred Shares on such of the said Shares as the Corporation intends to redeem or repurchase or in respect of such Class "D" Preferred Shares as the holders thereof have demanded redemption;

(ii) the holders of the Class "D" Preferred Shares shall not be entitled to participate further in the profits of the Corporation or in the assets of the Corporation except as herein specifically provided;

(iii) the Corporation or a holder of Class "D" Preferred Shares may, upon giving notice as hereinafter provided, redeem, repurchase, or have redeemed, at any time after the issuance of such Class "D" Preferred Shares, the whole, or from time to time, part of the then outstanding Class "D" Preferred Shares on payment for each share to be redeemed or repurchased, of One Hundred Dollars ($100.00), together with all dividends which have been declared by the Directors in the fiscal year of the Corporation and which are unpaid, if any ("the Redemption Value");

(iv) in the event the Corporation determines to redeem or repurchase Class "D" Preferred Shares, the Corporation shall at least thirty (30) days prior to the date specified for redemption or repurchase, mail to each person who at the date of mailing is the registered holder of Class "D" Preferred Shares to be redeemed or repurchased, a notice in writing of the intention of the Corporation to redeem or repurchase Class "D" Preferred Shares. Such notice shall be mailed in a prepaid letter addressed to each holder of Class "D" Preferred Shares at his address as it appears on the books of the Corporation or in the event of any Shareholder not so appearing, then to the last known address of such Shareholder; provided, however, that accidental failure to give any such notice to one or more Class "D" Preferred Shareholder shall not affect the validity of such notice of redemption or intention to repurchase. Such notice shall set out the date on which redemption or repurchase is to take place and if part only of the Class "D" Preferred Shares held by the person to whom the notice is addressed, are to be redeemed or repurchased, the number thereof. On or after the date so specified for redemption or repurchase, the Corporation shall pay or cause to be paid to or to the order of the registered holder of Class "D" Preferred Shares to be redeemed or repurchased, the Redemption Value for each share, on presentation and surrender at the head office of the Corporation, or such other place as may be designated in the notice, of the Certificates for the Class "D" Preferred Shares to be redeemed or repurchased. Such Class "D" Preferred Share shall thereupon be, and be deemed to be redeemed and shall be cancelled. If a part only of the Class "D" Preferred Shares represented by any Certificate be redeemed or repurchased, a new Certificate for the balance of the said shares shall be issued to the holder at the expense of the Corporation. From and after the date specified in the notice, the Class "D" Preferred Shares called for redemption or repurchase shall cease to be entitled to dividends and the holders thereof shall not be entitled to exercise any of the rights of holders of Class "D" Preferred Shares, unless payment of the Redemption Value for each share shall not be made upon presentation of Certificates in accordance with the provisions herein contained, in which case the rights of the holders shall remain unaffected. Should the holders of Class "D" Preferred Shares called for redemption or repurchase fail to present the Certificates representing such shares on the date specified for redemption or repurchase, the Corporation shall have the right to deposit the Redemption Value for each share of such shares in a special account in any Chartered Bank or any Trust Company in Canada to be paid without interest to or to the order of the respective holders of such Class "D" Preferred Shares called for redemption or repurchase upon presentation and surrender to such Bank or Trust Company of the Certificates representing the same and upon such deposit being paid the Class "D" Preferred Shares in respect whereof such deposit shall have been made shall be deemed to be redeemed or repurchased and shall be cancelled and the rights of the holders thereof after such deposit shall be limited to receiving, without interest, their proportionate part of the total Redemption Value for each share so deposited against presentation and surrender of the Certificates for Class "D" Preferred Shares held by them respectively;

(v) in the event any Shareholder requests that the Corporation redeem or repurchase any or all of that Shareholder's Class "D" Preferred Shares, the Shareholder shall at least thirty (30) days prior to the date specified for redemption or purchase, mail to the Corporation a notice in writing of the intention of the Shareholder to request that the Corporation redeem or purchase any or all of the Shareholder's Class "D" Preferred Shares. Such notice shall be mailed in a prepaid letter addressed to the head office of the Corporation or to the registered address of the Corporation in the province in which the Corporation is incorporated. Such notice shall set out the date in which redemption or purchase is to take place and the number of Class "D" Preferred Shares to be redeemed or purchased. On or after the date so specified for redemption or purchase, the Corporation shall pay or cause to be paid to or to the order of the registered holder of the Class "D" Preferred Share to be redeemed or purchased, the redemption or purchase price, on presentation and surrender at the head office of the Corporation, or such other place as may be agreed upon by the Shareholder and the Corporation, of the Certificates for Class "D" Preferred Shares to be redeemed or purchased. Such Class "D" Preferred Shares shall thereupon be, and be deemed to be redeemed and shall be cancelled. If a part only of the Class "D" Preferred Shares represented by any Certificate be redeemed or purchased, a new Certificate for the balance of the said shares shall be issued to the holder at the expense of the Corporation. From and after the date specified in the notice, the Class "D" Preferred Shares for redemption or purchase shall cease to be entitled to dividends and the holders thereof shall not be entitled to exercise any of the rights of holders of Class "D" Preferred Shares, unless payment of the redemption or purchase price shall not be received upon presentation of the Certificates in accordance with the provisions herein contained, in which case the rights of the holders shall remain unaffected;

(vi) subject to paragraph (a)(iii); paragraph (b)(ii); paragraph (c)(ii) and paragraph (d)(vii), the Directors of the Company are in no way restricted in their discretion to pay dividends on the Class "A" Voting Shares and/or the Class "B" and/or the Class "C" Non-Voting Shares to the exclusion of, or in addition to, the Class "D" Preferred Shares in any year;

(vii) in the event of the liquidation or winding-up of the Corporation whether voluntary or involuntary, or on a distribution of assets when the Corporation has ceased to carry on business, the holders of the Class "D" Preferred Shares shall be entitled to be paid out of the assets of the Corporation the Redemption Value for each share in priority to, and before any part of the assets are paid to or distributed amongst the holders of the Class "A", Class "B" and Class "C" Shares of the Corporation;

(viii) no dividends shall at any time be declared, paid or set apart for the Class "A", Class "B" and Class "C" Shares if such dividends would impair the ability of the Corporation to redeem or repurchase the Class "D" Preferred Shares;

(ix) any preference, right, condition, privilege or restriction attaching to the Class "A", Class "B", Class "C" Shares or the Class "D" Preferred Shares, may only be amended by a three-fourths majority vote of the holders of the existing Class "D" Preferred Shares, the Class "A" Shares, Class "B" and the Class "C" Shares, each class of Shareholders voting separately.